

no basis for each of these concerns. Moreover, as discussed in Section V below, even if such concerns existed, dominant carrier regulations are ill-suited to address them.

**A. EXPIRATION OF STRUCTURAL SEPARATION REQUIREMENTS  
WOULD NOT ENHANCE ILECS' INCENTIVE OR ABILITY TO  
ENGAGE IN NON-PRICE DISCRIMINATION AGAINST RIVALS IN  
PROVIDING NETWORK ACCESS**

46. The incentive and ability for ILECs to engage in non-price discrimination in providing rival long distance carriers access to local telephone networks depends on the ability of long distance firms and regulators to detect such actions as well as the penalties that result if discrimination is detected. Expiration of the structural separation requirements, however, affects only how ILECs structure their internal operations, not their incentive or ability to engage in non-price discrimination.

47. In order for discrimination to succeed, it must be effective enough to cause customers to switch to ILEC long distance services from those provided by other firms but, at the same time, must avoid detection by regulators and sophisticated rivals, such as AT&T, Sprint and MCI. These firms operate nationally and thus have numerous benchmarks available to evaluate whether an individual ILEC is engaging in non-price discrimination.

48. There is no basis to conclude that elimination of structural separation rules would alter ILECs' incentive to engage in non-price discrimination. For example, elimination of structural separation rules does not reduce the penalties associated with discrimination, which include fines, the potential loss of the authority to provide long distance services, and exposure to antitrust penalties.

49. In addition, a variety of other regulatory safeguards against unreasonable non-price discrimination by ILECs against long distance rivals would remain in effect following expiration of structural separation requirements. These include:

- Equal access requirements (to the extent the Commission determines they remain necessary) and non-discrimination provisions of Section 251 of the Telecommunications Act;<sup>46</sup>
- Nondiscrimination requirements under Sections 201 and 202 of the Telecommunications Act.<sup>47</sup>
- Prohibitions on discrimination under various state statutes.<sup>48</sup>

50. Moreover, the reporting requirements imposed on BOCs to measure their provision of access services remain in effect after expiration of the separate subsidiary requirements. These include BOCs' obligations to disclose "network changes affecting competing service providers' performance or ability to provide telecommunications services, as well as changes that would affect the incumbent LEC's interoperability with other service providers."<sup>49</sup> ILECs also are subject to rigorous measurements that detail their performance in providing unbundled network elements, interconnection and related services.<sup>50</sup>

**B. EXPIRATION OF STRUCTURAL SEPARATION REQUIREMENTS WOULD NOT ENHANCE ILECS' INCENTIVE OR ABILITY TO PURSUE A PREDATORY "PRICE SQUEEZE"**

51. The FNPRM requests comment on whether expiration of structural separation requirements would increase ILECs' incentive or ability to harm competition by engaging in a predatory "price squeeze."

52. A predatory "price squeeze" is said to occur when an ILEC sets retail prices for long distance service that are sufficiently near (or even below) the prices it charges its long

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46. See FCC, *Non-Accounting Safeguards Order*, 11 FCC Rcd. 21905, December 24, 1996, ¶271.

47. *Id.*, ¶211.

48. *Id.*, footnote 509.

49. *Id.*, ¶208.

50. See, for example, FCC, *Qwest 271 Order for Minnesota*, FCC 03-142, June 26, 2003, ¶10, Appendices B and C (performance measures).

distance rivals for access to its local network that equally efficient rivals will be driven from the market. This can be accomplished by an ILEC lowering its retail long distance prices, raising access prices charged to its long distance rivals, or both.

53. A price squeeze is a competitive concern if it is used to predate. In pursuing this strategy the ILEC sacrifices revenue with the goal of driving its rivals from the market and later recouping its investment in the form of higher retail prices. However, there is no basis for concern that expiration of the structural separation requirement will affect ILECs' incentive or ability to pursue a predatory "price squeeze."

54. The foremost reason is that it is widely recognized that predation is rarely a profitable strategy.<sup>51</sup> As noted above, firms that engage in predation incur some short-run losses in order to obtain longer-term gains. In order for predation to be successful, it is essential that attempts by the surviving firm to raise price (after driving its rivals from the market) do not result in entry. If entry occurs, firms will not be able to sustain the increase in price necessary to make predation a profitable strategy.

55. It is highly unlikely that a predatory strategy would succeed in the long distance industry. First, the industry includes several large, well-established rivals which include both wireline long distance carriers and wireless service providers. In addition, much industry investment consists of fixed assets, such as copper plant, fiber optic plant, switches and other equipment. These assets are likely to remain available to a new entrant, even if existing long distance companies are driven from the market. Thus, it would be difficult for a firm engaging

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51. See, for example, D. Carlton and J. Perloff, Modern Industrial Organization, Third Edition, pp. 334-342, which concludes (p. 342): "Given all the theoretical difficulties with successful predatory pricing, it is not surprising that economists and lawyers have found few instances of successful price predation in which rivals are driven out of business and prices then rise."

in predation to prevent firms from entering the industry by purchasing these assets after the predator attempted to raise price in order to recoup its investment.<sup>52</sup>

56. The current bankruptcies in the telecommunication industry highlight this point. In particular, the assets of firms now in bankruptcy firms typically have not exited the industry. Instead, bankrupt telecommunications firms (such as MCI WorldCom) are expected to remain in the industry and to emerge as effective competitors (with greatly reduced debt). As Morgan Stanley summarizes:

As the monthly operating results demonstrate, WorldCom is alive and competing. The company at the very least will re-emerge and try to give it a go. In an environment of limited demand and a possible shrinking pie in 2003, Sprint and AT&T have to contend with WorldCom's continuing seat at the table.<sup>53</sup>

57. Even if an ILEC could eliminate competition through predatory pricing, it is unlikely that the ILEC would be able to recoup its losses because it would likely face re-regulation as the result of its new monopoly status. In addition, it could face large penalties under antitrust laws. Thus, it is highly unlikely that ILECs could ever recoup investments in predation and thus it is highly unlikely that any such strategy would be pursued.

58. In any event, there is no basis to conclude that elimination of structural separation requirements has any impact on the ability of the Commission or ILECs' long distance rivals to scrutinize ILEC pricing and detect predation.

**C. EXPIRATION OF STRUCTURAL SEPARATION REQUIREMENTS  
WOULD NOT ENHANCE ILECS' INCENTIVE OR ABILITY TO  
ENGAGE IN COST SHIFTING**

59. The FCC has also expressed concern about an ILECs' ability to shift costs from its long distance division to its local service subsidiary. The FCC discusses two potential

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52. The FCC recognizes this point in LEC Non-Dominance Order, ¶107.

53. Morgan Stanley, Wireline Telecom Services – Trend Tracker: Bottom Line Better, May 23, 2003, p. 31.

concerns: (i) cost shifting may be used to facilitate a price squeeze; and (ii) cost shifting may be used to evade regulation and raise the price of regulated services.<sup>54</sup> This section shows that there is no basis for either concern.

**1. Expiration of structural separation requirements will not enable ILECs to engage in predatory conduct by improperly shifting costs**

60. For the purposes of determining whether an ILEC is to be classified as a “dominant” long distance carrier, the FCC has previously recognized that the only relevant issue is whether cost shifting can be used to facilitate predation and drive rival long distance carriers from the market.

For purposes of determining whether the BOC interLATA affiliates should be classified as dominant, however, we must consider only whether the BOCs could improperly allocate costs to such an extent that it would give the BOC interLATA affiliates ... the ability to raise prices by restricting their own output. We conclude that, in reality, such a situation could occur only if a BOC's improper allocation enabled a BOC interLATA affiliate to set retail interLATA prices at predatory levels (i.e., below the costs incurred to provide those services), drive out its interLATA competitors, and then raise and sustain retail interLATA prices significantly above competitive levels.<sup>55</sup>

61. There is no basis for concern that the expiration of structural separation requirements would enable ILECs to engage in predatory conduct by improperly shifting costs from long distance to local operations. This is because there is no logical connection between a firm's ability to shift costs and its incentive or ability to pursue a predatory strategy.

62. As discussed above, predation requires a firm to sacrifice profits (relative to the level that otherwise would prevail) during the period in which its rivals are driven from the

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54. The FCC summarizes this concern in its LEC Non-Dominance Order (¶103): “[I]mproper allocation of costs by a BOC is of concern because such action may allow a BOC to recover costs from subscribers to its regulated services that were incurred by its interLATA affiliate in providing competitive interLATA services. In addition to the direct harm to regulated ratepayers, this practice can distort price signals in those markets and may, under certain circumstances, give the affiliate an unfair advantage over its competitors.”

55. FCC, LEC Non-Dominance Order, ¶103.

market. In the unlikely event that such a strategy was profitable, the firm could finance its “investment” in a number of ways, including using earnings from a structurally separate subsidiary or even through borrowing in financial markets. A firm’s ability to shift costs is not necessary to “fund” predatory conduct. Nonetheless, for reasons described above, it is very unlikely that any predatory strategy could succeed in the telecommunications industry, and thus it is unlikely that any would be attempted.

**2. It is unlikely that expiration of separate subsidiary rules will enable ILECs’ to evade regulation by shifting costs**

63. It is unlikely that expiration of structural separation rules would give firms the incentive or ability to evade regulation by shifting significant costs from their long distance to local operations. As noted above, the FCC acknowledges that the evasion of regulation alone does not raise competitive concerns unless it is likely to give rise to predation -- which is highly unlikely in this industry. Furthermore, as discussed below, application of dominant carrier is inappropriate for addressing concerns that ILECs can evade regulations by shifting costs.

64. Nonetheless, it is important to note there is now little if any incentive for integrated carriers to avoid regulation by shifting costs because prices for regulated rates for local services, including exchange access and local exchange services, are largely set independently of the costs reported by ILECs. If shifting costs from long distance to local operations does not enable firms to generate higher revenue through higher prices of regulated services, there is no incentive to do so.

65. For example, interstate access charges today are governed by the CALLS order (Coalition for Affordable Local and Long Distance Service).<sup>56</sup> Under this order, a five-year

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56. FCC, Order in the Matter of Access Charge Reform Price Cap Performance Review for Local Exchange Carriers Low-Volume Long Distance Users Federal-State Joint Board On Universal Service, CC Docket No. 96-262, CC Docket No. 94-1, CC Docket No. 99-249, CC Docket No. 96-45, May 31, 2000.

schedule of access rates was established that lowered traffic-specific rates to \$.0055 per minute with further adjustments over time based on productivity trends.

66. Furthermore, prices for local exchange services and intrastate access services are subject to price cap formulas or other forms of incentive regulation and thus are not directly affected by changes in reported costs. For example, a number of states simply apply the CALLS rate for interstate access charges in setting intrastate access charges. While price cap and incentive regulation formulas differ from state to state, such regulations lessen or eliminate the relationship between an ILEC's reported costs and the prices it can charge for regulated services. According to a June 20, 2003 Communications Daily white paper, nearly all states use price caps, revenue caps or related forms of incentive regulation.<sup>57</sup> Only six states, which account for roughly five percent of the U.S. population, continue to regulate BOCs using rate of return regulation (although additional states continue to use rate of return regulation to regulate some independent ILECs). Even in states where rate of return regulation is still used, however, regulators can look to areas where price caps are used as benchmarks in establishing regulated rates, as well as other regulatory safeguards.

**D. ELIMINATION OF SEPARATE SUBSIDIARY REQUIREMENTS FOR OTHER ILEC BUSINESSES HAS NOT RESULTED IN HARM TO COMPETITION**

67. Available evidence indicates that removal (or absence) of structural separation requirements for various ancillary ILEC businesses has not adversely affected competition. These experiences provide no basis for concern that expiration of structural separation requirements relating to ILECs' long distance will harm consumers.

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57. "Retail Rate Regulation of Local Exchange Providers in the U.S.," Special White Paper Supplement to Communications Daily, June 20, 2003.

68. In the past, the FCC required that ILECs provide a variety of ancillary services, including customer premises equipment (CPE) and enhanced services, through separate subsidiaries. The FCC's concerns motivating these restrictions were similar to those discussed in the FNPRM with respect to ILEC provision of long distance services. In the Computer III order in 1986, the FCC summarized concerns that motivated the structural separation requirements:

We were particularly concerned that major carriers could use their control over basic services to discriminate against others' competitive services and products. We were also concerned that these carriers could misallocate costs from unregulated to regulated activities, allowing them to impose unfair burdens on regulated ratepayers and improperly cross-subsidize their competitive offerings.<sup>58</sup>

69. The FCC later removed these structural separation requirements relating to CPE and enhanced services after concluding that the costs of such restrictions outweighed their benefits, concluding that nonstructural safeguards were sufficient to address their concerns.

We conclude that in light of the high costs of mandatory structural separation the public interest would be better served by providing the BOCs with more flexibility in organizing their CPE and network services operations, while relying on effective, alternative methods to prevent improper cross-subsidization and discrimination.<sup>59</sup>

70. At the time that structural separation requirements were eliminated in 1987, rate of return regulation was prevalent and there were much stronger incentives than today for ILECs to engage in cost shifting. Nonetheless, we are aware of no evidence (or even claims) of competitive harm from the elimination of the structural separation requirements relating to CPE and enhanced services more than 15 years ago.

71. In addition, the FCC previously allowed separate subsidiary requirements relating to ILEC provision of interLATA information services to expire<sup>60</sup> and has permitted ILECs to

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58. FCC, Computer III Order, 104 FCC 2d 958, June 16, 1986, ¶12.

59. BOC Structural Relief Order, 2 FCC Rcd. 143, January 12, 1987, ¶2.

60. FCC, Order in the Matter of Request for Extension of the Sunset Date of the Structural, Non-Discrimination and other Behavioral Safeguards Governing Bell Operating Company Provision of In-Region, InterLATA Information Services, FCC 00-40, February 8, 2000.



provide intraLATA toll services on an integrated basis with local services. The non-price discrimination, price squeeze and cost shifting concerns raised by the FCC in the FNPRM regarding long distance services would seem to equally apply to these services. We are unaware of any evidence that expiration of these rules has adversely affected competition in the provision of these services.

**V. IMPOSITION OF DOMINANT CARRIER REGULATION WOULD NOT ADDRESS THE FCC'S STATED CONCERNS AND WOULD HARM CONSUMERS**

72. The FNPRM asks whether, and to what extent, dominant carrier regulation of interstate interexchange services is suited to achieving the Commission's objectives. In its notice, the FCC recognizes that dominant carrier regulation -- which could require ILECs to file tariffs and may subject ILEC long distance service to retail price cap regulation -- is not well suited to addressing the competitive concerns that have been raised:

[t]he regulatory requirements on a carrier classified as dominant in a particular market generally are designed to prevent a carrier from raising prices by restricting its output rather than to prevent a carrier from raising its prices by raising its rivals' costs; therefore, application of these regulations to a carrier that does not have the ability to leverage its market power by restricting its own output could lead to incongruous results.<sup>61</sup>

73. The Commission's evaluation of the limitations of dominant carrier regulation in addressing its concerns is well founded. Given the current status of the long distance industry and existing safeguards, the imposition of dominant carrier regulation would not only be inappropriate, but would impose unwarranted costs and distortions on the industry.

**A. THE FCC'S COMPETITIVE CONCERNS ARE NOT ADDRESSED BY DOMINANT CARRIER REGULATION**

74. As discussed earlier, the FCC has expressed concerns about the extent to which sunset of structural separation rules would enable ILECs to engage in non-price discrimination or

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61. FNPRM ¶38.

predation against their long distance rivals. While we conclude above that there is no basis for these concerns, even if there were, dominant firm regulation would not address them.

75. First, tariffs and price caps would not address concerns about non-price discrimination by ILECs against their long distance rivals. As discussed above, the incentive and ability of ILECs to engage in non-price discrimination depends critically on the ability of customers, rivals and regulators to detect it. As noted earlier, successful discrimination requires that these actions be noticeable to consumers (in order to induce them to switch to ILEC-supplied services) but must escape notice by competitors and regulators.

76. However, neither tariffs nor price caps affect the ability of consumers, rivals or regulators to detect non-price discrimination.<sup>62</sup> Even if an ILEC could engage in non-price discrimination against a competitor, regulation of the ILEC's long distance prices would not affect its ability to do so. As discussed earlier, regulators and long distance providers now have many years of experience in monitoring ILEC obligations with equal access and other non-discrimination requirements and the national scope of the major long distance companies leaves them numerous benchmarks for evaluating the performance of a given ILEC in providing interconnection with their local networks.

77. Second, price caps and tariffs would not address predation concerns. As discussed earlier, successful predation requires that a firm accept short-term losses while driving its rivals from the market. However, dominant carrier regulations would not prevent this conduct. As noted above, the FCC recognizes that tariff requirements and/or price cap regulations are typically intended to prevent companies from setting prices that are considered too high, not to prevent firms from lowering prices. If tariffs or price caps were to deter firms

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62. Instead, tariffs or price cap regulation, at best, may deter a BOC from raising price if discrimination was successful. (LEC Non-Dominance Order ¶87)

from reducing prices (and we are not aware of any suggestion in the FNPRM that this is the FCC's goal), there would be obvious anticompetitive consequences of discouraging legitimate price competition.

78. While the FCC has suggested in the past that tariffs supported by detailed cost data may help identify predation,<sup>63</sup> such behavior should be readily identifiable in the absence of tariffs. For example, the execution of a price squeeze requires that ILECs charge retail prices at a sufficiently low level that an equally efficient rival will be driven from the market. It is likely that any such attempt could be readily detected by ILECs' rivals and regulators, especially given access charge reforms in recent years that have greatly lowered usage sensitive access charges (while raising fixed charges).<sup>64</sup> Given what we understand to be the relatively low marginal (or variable) costs facing long distance suppliers, execution of a price squeeze would require that the ILEC set a very low retail price, which should be readily identifiable.

**B. INAPPROPRIATE APPLICATION OF DOMINANT CARRIER REGULATION CAN ADVERSELY AFFECT COMPETITION**

79. The FCC has correctly acknowledged in prior proceedings that there are significant costs associated with establishing tariffs and other regulations and that inappropriate application of dominant carrier regulation may adversely affect competition.

[T]he fact that these measures might help to deter a BOC or its interLATA affiliate from engaging in certain types of anticompetitive conduct is not, by itself, a sufficient basis for imposing dominant carrier regulations on the BOC interLATA affiliates. We should also consider whether and to what extent these regulations would dampen competition...<sup>65</sup>

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63. *Id.*, ¶87.

64. FCC, CALLS Order, FCC 00-193, May 31, 2000 ¶¶29-30; FCC, Trends in Telephone Service, May 2002, Table 1.2.

65. LEC Non-Dominance Order, ¶ 87.

80. The FCC has previously found that tariffing requirements can harm competition by facilitating tacit collusion through the exchange of pricing information.<sup>66</sup> The FCC also recognizes that tariffs encourage ILECs' rivals to challenge ILECs' rates "in order to impede [BOCs'] ability to compete."<sup>67</sup>

81. The FCC has found, correctly in our view, that these regulations can deter competition in a variety of additional ways, including (i) discouraging the introduction of innovative new service offerings; (ii) reducing the ability of firms to engage in price competition, including offering secret discounts; (iii) limiting the ability of firms to rapidly respond to changes in market conditions; and (iv) deterring firms from developing customer-specific service offerings.<sup>68</sup>

## VI. CONCLUSION

82. Permitting BOCs and independent ILECs to integrate their long-distance and local exchange operations will not adversely affect competition. As a result, there is no economic basis for imposing dominant firm regulation on BOCs or independent ILECs.

83. Competition in the provision of long distance service has increased dramatically since 1995 when the FCC determined that AT&T should not be subject to dominant carrier regulation.

- BOCs' in-region share of wireline long distance service is expected to remain well below AT&T's 1995 share and, on a national basis, each BOC is expected to account for less than 10 percent of wireline services.

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66. *Id.*, ¶89.

67. *Id.*

68. Policy and Rules Concerning the Interstate, Interexchange Marketplace, 11 FCC Rcd. 20, 730 at ¶¶23, 53.

- Competition from wireless services, e-mail and instant messaging – as well as massive increases in industry capacity -- has resulted in large declines in wireline long distance usage and declining prices.

84. In addition, ILECs would not be able to harm competition in the provision of long distance service by manipulating access to their local networks in the absence of structural separation regulations.

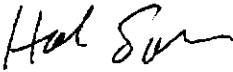
- Elimination of structural separation rules does not alter the ability of customers, rival long distance providers or regulators to detect discrimination and thus does not affect BOCs' incentive or ability to engage in non-price discrimination.
- There is no basis to conclude that elimination of structural separation rules would enable ILECs to engage in a predatory price squeeze. Predation is rarely a profitable strategy and its is especially unlikely in the telecommunications industry because entry (or re-regulation) would preclude recoupment.
- There is no basis to conclude that elimination of structural separation rules would enable firms to fund predation, or even evade regulation, by shifting costs.

85. Finally, dominant carrier rules do not address the competitive concerns raised by the Commission. These rules are designed largely to prevent anticompetitive price increases, but competitive concerns relating to manipulation of access focus primarily on predatory price reductions and non-price discrimination.

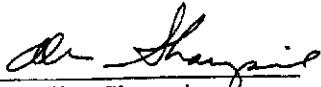
I declare under penalty of perjury that the foregoing is true and correct to the best of our knowledge and belief.



Dennis W. Carlton



Hal Sider



Allan Shampine

June 30, 2003